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CRISILEconomyFirstCut- BoP

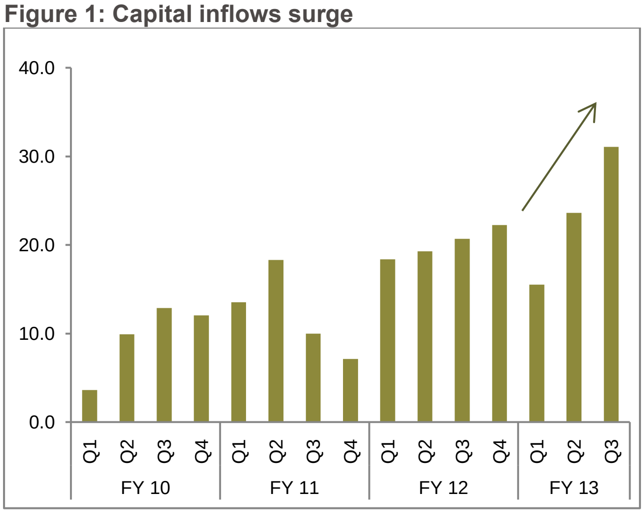
What if the big river of inflows dries up?

Overview: If the river flows, life flourishes. If capital inflows flow, the currency fares well. This is especially true when large inflows are required to fund the ballooning current account deficit (CAD) of a country. While India's current account deficit hit a record high of US$ 32.6 billion (6.7 per cent of GDP) in October-December 2012, capital inflows were sufficient to cover the deficit. As a result, the rupee did not depreciate during Q3FY13 relative to the previous quarter.

While exports have begun to recover, high import requirements, especially energy imports imply that the demand for US$ will remain high in 2013-14 as well. Hence, India will need the river of capital inflows to continue and provide support to the rupee. We believe that if the domestic reform momentum continues, India should be able to attract sufficient inflows to cover its CAD in the next fiscal. If however, there are any signs of a global economic drought, capital flows can dry up suddenly resulting in a temporary, but a sharp depreciation of the rupee.

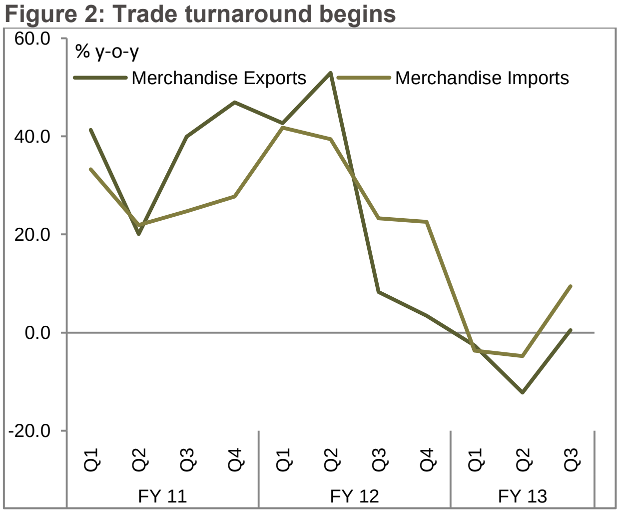
- CAD surged in Q3FY13 on the back of a record merchandise trade deficit of US$ 59.6 billion (12.3 per cent of GDP). While exports grew at 0.5 per cent compared to a year ago, a strong growth in oil and gold imports increased imports by 9.4 per cent. A sustained increase in trade deficit tends to indicate a wider structural weakness in the economy – a high level of import demand combined with a loss of export competitiveness.
- Net FDI inflows fell to US$ 2.5 billion in Q3FY13 from US$ 8.9 billion in Q2FY13. In contrast, net portfolio investment rose to US$ 8.6 billion in Q3FY13 as against US$ 7.6 billion in the previous quarter. As per SEBI data net FII inflows have rose further to around US$ 12.0 billion in Q4FY13. This suggests that India received its highest net FII inflows ever in 2012-13, despite domestic economic slowdown. Given the volatility of these inflows, dependence on FII inflows for funding high CAD exposes the economy to a sudden decline in rupee.
- With a surge in the import bill, India's import cover (in months) of foreign exchange reserves has fallen steadily in the recent years. With reserves of around US$ 297 billion at end-December 2012 the import cover has fallen to around 7 months as against over 11 months in March-2010. Internationally, 3 months of import cover is deemed necessary as a protection against an external shock.

Figure 1: Capital inflows surge



Source: RBI, CRISIL Research

Figure 2: Trade turnaround begins



Source: RBI, CRISIL Research

- The oil import bill in Q3FY13 remained firm despite oil prices increasing only slightly due to robust demand. Gold and silver imports grew at a fast pace of 24.0 per cent after having contracted in the previous quarter.
- External debt stock increased by US$30.8 billion and stood at US$376.3 billion by December-end 2012. The rise in the external debt was primarily due to an increase in NRI deposits, commercial borrowings and short-term trade related credits. Share of short-term debt increased to around 24.4 per cent of the entire external debt from 23.1 per cent in September-end 2012. The foreign exchange reserve available to cover the external debt fell further to 78.8 per cent by December-end 2012, down from 80.7 per cent in June-end 2012, indicating higher stress.

Analytical Contacts:

Vidya Mahambare
Principal Economist, CRISIL Research
Email: vidya.mahambare@crisil.com

Aindrila Roy Chowdhury
Economic Analyst, CRISIL Research
Email: aindrila.chowdhury@crisil.com

Media Contacts:

Priyadarshini Roy
Communications and Brand Management
Email: priyadarshini.roy@crisil.com
Phone: +91 22 3342 1812

Jyoti Parmar
Communications and Brand Management
Email: jyoti.parmar@crisil.com
Phone: +91 22 3342 1835

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CRISIL Limited
CRISIL House, Central Avenue, Hiranandani Business Park,
Powai, Mumbai – 400076. India
Phone: +91 22 3342 3000 | Fax: +91 22 3342 8088
www.crisil.com